United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

ORIGINAL 75-5021

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

In the Matter

of

FLYING MAILMEN SERVICE, INC.,

Bankrupt

CHARLES GOLD,

Plaintiff-Appellant,

v.

HERBERT K. LIPPMAN, Trustee in Bankruptcy of Flying Mailmon Service, Inc.

Defendant-Appellee

B P/S

BRIEF FOR APPELLEE

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-against-

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Defendant-Appellee.

BRIEF FOR APPELLEE

THE ISSUES

1. The District Court did not err in denying appellant status as a secured creditor for the full unpaid balance of his claim.

2. Remand is required to determine the date of the insolvency of the Bankrupt for a proper allocation of the monies involved and to allow the Appellee to move to amend his answer.

STATEMENT OF THE CASE

Charles Gold, appellant herein, was a stockholder of Appellee Flying Mailmen Service. Inc. (a. 2)

On September 18, 1970, appellant herein commenced an action in the New York Supreme Court, County of New York, by way of an Order to Show Cause, which order asked for the dissolution of the Flying Mailmen Service, Inc.; the appointment of a receiver pending the dissolution and the restraining of the officers and directors of the Corporation from withdrawing any corporate funds or otherwise disposing of any of the property or assets of the Corporation. (a. 1,2)

With the granting by the Court of the above request, the affairs of the Corporation were brought to a standstill. (a. 2) The litigation led to a destruction of any normalcy of business and brought the Corporation, its officers and directors to their knees. We come now to the Agreement of December 16, 1970, which is little more than a recitation of economic blackmail in the form of a basic document around which this entire litigation turns. (a. 6)

This agreement specifically provides, among other things, the following:

1. The termination of the lawsuit between Charles Gold and the Flying Mailmen Service, Inc. (a. 2,8)

2. Payment to Gold of $150,000, 17% of which was attributable to settlement of any claims by Gold against the Corporation and 83% being the consideration for the purchase of Gold's shares in the Corporation. (a. 2,9,10)

3. Upon signing the agreement the payment to Gold of $57,500 by certified bank or attorney's check and in addition 18 bi-monthly payments of $5,138.88 starting March 1, 1971. (a. 2,10)

4. The Corporation by reason of a handwritten addition to the above agreement agreed to waive any claim against Gold for the Litton Industry Stock and the $5,000 check drawn to the order of United Crown, Ltd. and marked "Telestar Loan". (a. 2,24)

5. The contract, the performance and interpretation was to be governed under and by the law of the State of New York. (a. 30)

The financing statements as filed by appellant (a. 36), as provided for in the aforementioned agreement

did not state that Gold was a stockholder in the Flying Mailmen Service, Inc. and the statements secured the repurchase by Appellee of its own stock. (a. 2,3)

Thereafter, installments aggregating $25,500 were paid before the corporation filed a Chapter XI proceeding in January, 1972. (a. 3) Following the filing of the Chapter XI proceeding, appellant instituted a proceeding in the Bankruptcy Court for the enforcement of his alleged secured claim. (a. 3) By a decision dated June 16, 1972 and supplemented by a decision dated June 19, 1972, Bankruptcy Judge Asa S. Herzog denied appellant's claim to be treated as a secured creditor and ordered the refunding of $11,200 received by appellant while Mailmen was in Chapter XI. (a. 3,37 & 48) Before an order was entered pursuant to the said decisions, Gold and Mailmen compromised their differences, which compromise was approved by Judge Herzog. (a. 3) A creditor of Mailmen then took an appeal to the United States District Court opposing the compromise. (a. 3) Before the District Court could rule on the petition, Mailmen was declared a bankrupt and the petition was remanded to the Bankruptcy Judge. (a. 3) On remand Judge Herzog reaffirmed his decision of June 16, 1972 denying Gold's claim as a secured creditor. (a. 4,58)

Judge Herzog in his decision of July 1, 1974 did not treat the Trustee's argument as de novo and treated this as a reargument by Gold. The Trustee sought to challenge the agreement of December 1970 as unconscionable, but Judge Herzog did not consider this argument. (a. 4)

On appellant's appeal to the District Court, Judge Lasker upheld the Bankruptcy Court's denial of appellant's claim to be a secured credit. (a. 4) He also upheld the order to return the $11,200 paid after the Chapter XI filing. (a. 4) In addition he remanded the case to the Bankruptcy Court for a determination of the date of Mailmen's insolvency and to allow the Trustee in Bankruptcy to move to amend his answer. (a. 4)

The New York Business Corporation Law §§ 513(a) and 514(b) stand for the proposition that a corporation may repurchase its stock if such repurchase is made out of surplus except if the corporation is insolvent or would thereby be made insolvent. (a. 61,62) New York Business Corporation Law §102 para. 8 defines insolvent as follows: "Being unable to pay debts as they become due in the usual course of the debtors business."

Judge Herzog, in treating the remand from the

District Court as reargument rather than as de novo denied the Trustee in Bankruptcy the right to argue from a different position on the validity of the December 17, 1970 agreement and forced the Trustee to adopt the position of the Debtor in Possession which was not in the best interest of the creditors.

POINT I

THE SECURITY INTEREST GRANTED PURSUANT TO THE AGREEMENT OF DECEMBER 16, 1970 IS UNFORCEABLE.

New York Business Corporation Law §513(a) provides:

> "A Corporation, subject to any restrictions contained in its certificate of incorporation, may purchase its own shares, out of surplus except when currently the corporation is insolvent or would thereby be made insolvent."

Furthermore, Section 514(b) provides that an agreement by the Corporation for the purchase of its shares is enforceable only to the extent that the purchase is permitted at the time of payment. See *Baxter v. Lancer Industries, Inc.*, 213 F. Supp. 92 (E.D.N.Y. 1963).

Thus in *In re Bay Ridge Inn, Inc.*, 98 F.2d 85 (2d Cir. 1938), the Court held that §58 of the Stock

Corporation Law (the predecessor to §§ 513 and 514 of the Business Corporation Law) required that the claim of the seller of shares be subordinated to those of the general creditors of the bankrupt corporation, and *a fortiori* that the seller's lien be declared invalid notwithstanding the fact that the mortgage was duly recorded. Of similar import was *Engelken v. Shanty Shops*, 104 N.Y.S. 2d 970 (Sup. Ct. 1951).

In the *Bay Ridge* case, *supra*, at p. 86 the Court said as follows:

> "The suggestion that §58 should not be applied because the mortgage was duly filed and creditors had constructive notice of the lien created thereby is without merit...The record gave no notice to creditors of what actually occurred..."

We deal here with a statute limiting the power of a corporation to make payments. As stated in *First Trust Co. v. Ill. Cent. R. Co.*, 256 Fed. 830, 831 (8th Cir. 1919), "in the absence of statutory or character restriction, a corporation has inherent power to purchase its own stock." The case then goes on to give the common law rule, quoted by Gold, that the purchase of its shares by an insolvent corporation is voidable as to existing creditors and to subsequent creditors without knowledge.

However, we are here concerned with a statutory restriction which makes no distinction between a seller of the corporation's shares who takes a security interest and one who does not, or between subsequent creditors with or without knowledge of the transaction.

Even if the common law rule still applied, the result would be the same. The mortgage which was recorded in the *First Trust Co.* case, *supra*, stated:

> "Whereas it now appears necessary and proper for the purpose of purchasing 1,125 shares of its capital stock from its present shareholders,...the railroad company has now resolved to issue...bond."

On the other hand, the financing statements filed by appellant do not recite the consideration given. As indicated by *In re Bay Ridge Inn, Inc., supra*, filing without expressly telling what consideration was given can never be sufficient notice.

A few words must be said about the other cases cited by the appellant, all of which are cited out of context. In *Cross v. Bequelin* 252 N.Y. 262, 169 N.E. 378 (1929), the seller was permitted to recover from the parties to the agreement other than the corporation which had no interest in the controversy. In *Huron Milling Co.*

v. Hedges, 257 F.2d 258 (2d Cir. 1958), the Court misread *Cross v. Bequelin* in that as stated above, recovery in the *Cross* case was against parties other than the debtor corporation, and the Court, in fact, indicated that recovery was not proper against the debtor corporation.

In *In re Dawson Bros. Constr. Co.*, 218 F. Supp. 411 (N.D.N.Y. 1963) the impairment of a corporaion's capital structure which the Court was discussing was a reduction in the number of issued shares (payment out of capital). It should be noted that the Court held that constructive notice of capital impairment is not sufficient; that actual knowledge must be shown.

POINT II

PAYMENTS MADE WHILE DEBTOR WAS INSOLVENT OR WITHOUT SURPLUS MUST FIRST BE APPLIED TO THAT PORTION OF THE DECEMBER 16, 1970 AGREEMENT NOT RELATED TO THE REPURCHASE OF SHARES. THE SAME APPLIES IF PAYMENTS TO REPURCHASE SHARES WOULD RENDER DEBTOR INSOLVENT.

Although a creditor, in the absence of directions to the contrary, normally can apply payments to any debt owned by the debtor, payments made while a corporation is

without surplus must first be credited to claims other than those for monies due on the repurchase of the corporation's shares; *In re Bell Tone Records, Inc.*, 86 F. Supp. 806 (D.N.J. 1949). To rule otherwise would cause an unnecessary circuity of actions, with the corporation recovering monies improperly applied for the repurchase *Huron Milling Co. v. Hedges, supra*, and the creditor recovering on the remainder of the agreement. In the *Bell Tone* case at p. 810, the Court in distinguishing between a claim based on the repurchase of stock and a claim based on monies loaned to the debtor corporation said the following:

> "The claim of Shirly Droutman for the purchase price of the stock may not be accorded the usual priority notwithstanding the validity of the mortgages given to secure the payment. The recognition and payment of this claim as one entitled to priority would deplete, if not exhaust, the bankrupt estate to the injury of other creditors. This claim must, therefore be subordinated to the claims of other creditors notwithstanding the mortgages."

POINT III

THE AGREEMENT OF DECEMBER 16, 1970 IS VOID AND UNENFORCEABLE UNDER THE APPLICABLE STATUTES OF THE STATE OF NEW YORK.

The New York State Business Corporation Law Section 513 Subdivision (a) states:

> "A corporation, subject to any restrictions contained in its certificate of incorporation, may purchase its own shares, *out of surplus* except when currently the corporation *is insolvent or would thereby be made insolvent.*" [Emphasis ours.]

The Bankruptcy Judge herein, following the applicable statute and based on his finding that the debtor was insolvent at the time of the commencement of the Chapter XI, held that the executory portion of the agreement of December 16, 1970 and the security agreement given was unenforceable. His determination was limited to the date of the commencement of the Chapter XI proceedings and the rights and obligations commencing as of that date. Ignored was the contention as to the insolvency of the debtor (now Bankrupt) as of the date of the execution of the agreement of December 16, 1970. All the books, documents and records submitted in the Chapter XI proceeding clearly reveal that the insolvency existed on December 16, 1970.

Also revealed is that the Bankrupt could not meet its obligations on that date and therefore it was insolvent under New York law (Section 102 (a)(8) of the Business Corporation Law).

Indisputably the Bankruptcy Judge's decision was correct but it did not got far enough. The affirmative fact of the Bankrupt's being rendered insolvent as of the date of the signing of the agreement (dated December 16, 1970), was raised in the pleadings which are part of this record (answer of debtor, paragraphs 5 and 6) which reads as follows:

> "AS AND FOR A FIRST SEPARATE DEFENSE
> AND BY WAY OF A FIRST AFFIRMATIVE DEFENSE
> ON BEHALF OF THE DEBTOR IN POSSESSION
>
> 5. The agreement of December 16, 1970 is unenforceable in that it is in violation of §§ 513 and 514 of the Business Corporation Law of the State of New York in that the debtor is without surplus and accordingly cannot repurchase the shares of stock pursuant to the aforementioned agreement.
>
> AS AND FOR A SECOND SEPARATE DEFENSE
> AND BY WAY OF A SECOND AFFIRMATIVE DEFENSE
> ON BEHALF OF THE DEBTOR IN POSSESSION.
>
> 6. The security interest granted pursuant to the agreement of December 16, 1970 is likewise unenforceable by reason of the fact that the underlying obligation is unenforceable."

POINT IV

THE CONTRACT DATED DECEMBER 16, 1970 IS UNCONSCIONABLE AS A MATTER OF LAW AND IS THEREFORE UNENFORCEABLE AND ALL MONIES RECEIVED THEREUNDER BY APPELLANT SHOULD BE RETURNED.

The contract dated December 16, 1970 was unconscionable as a matter of law and is therefore unenforceable. The contract of December 16, 1970, was an attempt to settle the litigation between Charles Gold and the Flying Mailmen Service, Inc. It was the culmination of a lawsuit that had started in September, 1970 and attempted to set forth all the alleged grievances between the parties and a satisfactory resolution of them. A careful reading of these documents reveals that it is entirely one-sided, that, in effect, the Flying Mailmen Service Inc. acceded to all the demands of Charles Gold in an attempt to loosen his economic stranglehold on the Corporation and to proceed with the business for which it was formed.

Two outstanding examples of the unconscionability of the contract are as follows:

1. The hand-written addition to the contract that the Litton Industry Stock purchased by the Corporation at the suggestion of Charles Gold for the Corporation's

benefit and which stock was purchased in the name of Charles Gold at Gold's request with the stock broker be formally recognized by the Corporation as belonging to Charles Gold.

2. That the $5,000 given to Gold to purchase an interest by the corporation in a trucking company and which was placed in a corporate account fully controlled by Gold be recognized as belonging to Gold.

The foregoing serves to demonstrate the fact that the contract was not an arm's length transaction between two parties negotiating with equal strength, but rather one party conceding to the other party's wishes in order to effectuate a settlement at any cost to itself.

In asking this Court to void the entire contract, we are asking it to exercise and apply the principles and rules of equity jurisprudence. The Supreme Court upheld "...that a bankruptcy court has full power to inquiry into the validity of any claim asserted against the estate and to disallow it if it is ascertained to be without lawful existence." *Lesser v. Gray*, 236 US 70.

To all the foregoing must be added the fact that Gold was the Comptroller of the Corporation and in full

control of its finances and privy to its financial standing. Gold was also the owner of 49% of the issued and outstanding stock of the Corporation at the time this agreement was entered into. Gold was no mere litigant, at this time seeking to compromise a claim against a corporation, but was in fact in a fiduciary relationship with this corporation. "When challenged such fiduciary have the burden of establishing the good faith of the transaction upon which their claims are based,...the essential task of good faith and fairness is whether the transaction was an arm's length bargain." *In Re Brunner Air Compressor Corp.*, 287f subd. 256 p. 263 (E.D.N.Y. 1968). From the foregoing, it can easily be seen that Mr. Gold has miserably failed to meet the test as set forth above.

Pepper v. Litton, 308 U.S. 238, 1939 presents the classic case of an insider in a corporation using a variety of legal artifices to secure the assets of the corporation to his benefit to the exclusion of all other parties interested in the corporation. The Court disallowed Litton's scheme of attempting to use his inside position to establish himself as the major creditor of the corporation in an effort to protect himself in the

event that the Corporation would be declared insolvent. In the case involved, Gold has certainly trodden the same path.

Gold first, in effect, confiscated the liquid assets of the corporation by acquiring the Litton Industries Stock in his own name and by placing $5,000 given to him by the Corporation for the purchase of a trucking company in a corporation wholly owned by him. The second step of the scheme is the bringing of the lawsuit which effectively ties up all the other assets of the corporation and forces the corporation to its economic knees. The third step is the agreement of December 16, 1970 which solidifies its prior action and leads in turn to the fourth step which is the requirement that all the assets and stock of the corporation serve as collateral to Gold until heis paid the alleged money due him.

The Supreme Court in Litton announced the rule to be followed in such a case.

> "The mere fact that an officer, director or stockholder has a claim against a bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord it pari-passu treatment with the claims of other creditors. Its disallowance or subordination may be necessitated by certain carnal principles of equity jurisprudence."

Similarly, this Court should disallow the Agreement of December 16, 1970 in its entirety and order that all monies received by Gold as a result thereof should be returned to the Corporation forthwith.

POINT V

REMAND IS REQUIRED TO DETERMINE THE DATE OF THE INSOLVENCY OF THE BANKRUPT FOR A PROPER ALLOCATION OF THE MONIES INVOLVED AND TO ALLOW THE APPELLEE TO MOVE TO AMEND HIS ANSWER.

Quoting Judge Lasker (70a, 71a):

"However, even if the agreement is so construed, both parties are correct that the case must be remanded for determination of the date of insolvency. If the trustee is correct that the debtor was insolvent as of the date of the execution of the December 16, 1970 agreement, than none of the money paid Gold, either before or after the filing of the bankruptcy petition, can be allocated to the repurchase of stock debt and Gold would have to refund all monies received in excess of $25,000. On the other hand, if the Bankruptcy Judge found that insolvency occurred on a different date, the allocation would be affected accordingly.

The trustee in bankruptcy urges that we declare the settlement agreement of December 16, 1970 unconscionable and void. This defense was not asserted in the original answer to Gold's petition and the Bankruptcy Judge refused to consider the claim on reargument.

We believe that the Judge could properly refuse to hear the alleged counterclaim since the pleadings were not amended to include it and it was not a proper matter for reargument.

The decision on this point is therefore affirmed without prejudice to the exercise of such rights as the trustee may have to assert the claims hereafter.

The case is remanded to the Bankruptcy Court for further proceedings to determine the date of the debtor's insolvency, to apportion the monies received by Gold accordingly, and to allow the trustee to move to amend his answer."

CONCLUSION

THE DETERMINATION OF THE DISTRICT COURT SHOULD BE SUSTAINED.

Respectfully submitted,

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Appellee's Brief

IS HEREBY ADMITTED.

DATED: April 5, 1976

Hoyt St. John Abrams & Heilbron

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